Office-Supreme Court, U.S.
FILED
JUN 2 1966
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1965

No. ~~1970~~ 194

EQUITABLE PUBLISHING COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

HOWARD C. BERKY and EMMA M. BERKY, his wife,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

GEORGE W. KNIPE and DOROTHY K. KNIPE, his wife,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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COMMISSIONER OF INTERNAL REVENUE,
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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioners pray that a Writ of Certiorari issue to review the judgments of the United States Court of Appeals for the Third Circuit entered in the above-entitled cases on March 8, 1966.

OPINIONS BELOW.

The opinion of the Tax Court of the United States is Tax Court Memorandum Decision 1965-131. The Tax Court Memorandum Findings of Fact and Opinion is reported at 24 CCH TCM 668 (1965). It is printed in the Appendix for the use of the Court below at pages 331a-412a.

The opinion of the United States Court of Appeals for the Third Circuit, filed on March 8, 1966, is reported at 356 F. 2d 514 (1966), and is printed in Appendix A hereto, pages 22-23.

JURISDICTION.

The judgments of the Court of Appeals for the Third Circuit were entered on March 8, 1966 and are printed in Appendix B hereto, pages 23-25. The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1).

QUESTIONS PRESENTED.

1. Where the uncontradicted evidence establishes, and the detailed findings of fact of the Tax Court show, that two newspaper publishing corporations joined together in good faith to conduct a joint venture, having agreed that each should be compensated for its services aimed at increasing the advertising and subscription income of one, may the Tax Court substitute its own conclusion that there was no business purpose for the joint venture when the contrary conclusion was reached by the parties, by several disinterested publishers, by all newspaper industry expertise and by the actual results of the joint venture itself?

2. Where two corporations undertake a joint effort aimed at promoting and protecting the business income of one of them, should payments from one corporation to the other be taxed as dividends to the two stockholders of the corporation receiving the payments simply because these two unrelated individuals are controlling shareholders of the paying corporation—notwithstanding the undisputed facts that an independent businessman, representing a significant minority of shares in the paying corporation, approved the payments as being fair and appropriate for the services

rendered, his views are completely supported both by other witnesses and the documentary evidence which show the results achieved through the joint venture, and there is no evidence to the contrary?

STATEMENT OF THE CASE.

These three cases were instituted in the Tax Court of the United States by Equitable Publishing Company ("Equitable"), Howard C. Berky ("Berky") and Emma M. Berky,[1] and George W. Knipe ("Knipe") and Dorothy K. Knipe,[1] petitioners, challenging alleged deficiencies in federal income taxes for the years 1956 through 1960, inclusive.

These cases proceeded to trial before Tax Court Judge Graydon G. Withey. He filed an opinion (331a-412a)[2] which, inter alia, sustained the Commissioner's determination that various amounts annually regarded by Equitable as having been earned by North Penn Publishing Co. ("North Penn") in a joint venture should be added to Equitable's gross income and that such amounts should be treated as constructive dividends to Berky and Knipe.

Thereafter, on Petitions for Review filed by the taxpayers, the Court of Appeals for the Third Circuit (Circuit Judges McLaughlin, Forman and Ganey) affirmed.

Some of the facts were admitted in the answers (21a-22a, 47a-48a, 71a-72a) to the petitions (3a-20a, 28a-46a, 54a-70a). Many of the facts were submitted by stipulation of

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[1] Petitioners, Emma M. Berky and Dorothy K. Knipe are involved in these proceedings only by reason of having filed joint federal income tax returns with their respective spouses.

[2] Citations are to Appendix filed in the Court of Appeals.

counsel (76a-106a). The remaining facts were presented through petitioners' seven witnesses and exhibits offered in evidence by petitioners (122a-329a). The respondent offered no evidence.

The uncontradicted evidence showed the following facts:

Since 1927, Equitable, a Pennsylvania corporation, has published and sold a daily newspaper, known as the "North Penn Reporter" ("Daily Reporter"), every day except Saturday and Sunday, in Lansdale, Pennsylvania, a suburb of Philadelphia (336a). Until his death on October 20, 1947, Walter L. Sanborn owned most of Equitable's capital stock (337a). Knipe was first employed by Equitable in 1927, and Berky was first employed by Equitable in 1935 (336a-337a). At the time of Sanborn's death Knipe and Berky each owned 38 shares of Equitable's 740 issued and outstanding shares of capital stock (337a). Thereafter, Knipe and Berky acquired additional shares of Equitable's stock so that as of March 28, 1952, each of them owned 313 shares of the stock (337a-338a). Of the remaining shares, 112 were held by the Philadelphia National Bank as trustee for three trusts and two shares were held by Neil L. Conver (80a, 338a).

North Penn, a Pennsylvania corporation which is involved in the present litigation but is not a party to it, was incorporated on September 26, 1950, by four individuals not related to any of the present petitioners (338a). From the date of its incorporation, until the present, North Penn has been publishing and distributing each Thursday in the Lansdale, Pennsylvania area a publication known as the "North Penn News" ("Weekly News") (338a). The Weekly News had been published and distributed by individual proprietors, prior to the incorporation of North Penn, since approximately 1934 (338a-339a).

The Weekly News was and is what is known in the trade

as a "throwaway" because it is simply left at houses without charge. When operated aggressively by competent management, a throwaway publication can be a very profitable operation. Moreover, such a competitive throwaway creates a very dangerous threat to the continued profitable operation of any daily newspaper which is published and circulated within the circulation area of the throwaway. That result occurs for a variety of reasons, among them being that the throwaway is able to sell advertising at lower rates made possible by operating without the expense of a significant news-gathering service, by using cheap equipment and material and by emphasizing the large free (although unaudited) circulation of the weekly as compared to the smaller paid (although audited) circulation of the daily (127a-130a, 208a-209a).

The problem of danger to a subscription daily by a weekly throwaway has been particularly acute since the Second World War. It has been a matter of national concern, a great deal of discussion, considerable writing and common knowledge in the newspaper industry (130a, 303a-329a).

The problem of the danger to a subscription daily created by a weekly throwaway is particularly acute in suburban areas surrounding metropolitan areas (such as is the relationship between Lansdale and Philadelphia, Pennsylvania) because the suburban daily cannot compete favorably for reader interest on an international or national news level with the nearby big city newspapers (130a-132a).

The adverse effect upon the advertising income of a subscription daily caused by a weekly throwaway cumulatively causes an adverse effect upon the daily's subscription income. Advertising income and subscription income to a suburban daily newspaper are interrelated. Increased numbers of paid subscribers make the newspaper's ad-

vertising more valuable since the advertiser knows he is reaching more people with his message; in turn, increased numbers of local advertisers make possible increased subscription income because of the interest of local readers in local sales and purchase opportunities (135a).

However, up until 1952, the management of the Weekly News, both in its unincorporated and incorporated form, had not been ambitious or aggressive (197a, 363a). Nevertheless, even in the face of the limited competition of this incompetently managed throwaway, the advertising income of the Daily Reporter was adversely affected (171a-172a). Because of this incompetence in the management of the Weekly News, the Daily Reporter had been able to increase, in a limited amount, its advertising income prior to 1952 although not as much, of course, at it would have, had there been no competition from it (171a-172a). Then, in early 1952, Knipe and Berky learned that the owners and publishers of the Weekly News were planning to go out of business. Knipe and Berky thus faced three alternatives: (a) they could let that weekly paper disappear and hope the void would not be filled by a strong and dangerous entrepreneur; (b) they could let it go into the hands of third parties who might use it to compete aggressively and dangerously with Equitable's Daily Reporter; or (c) they could buy it to operate the Weekly News cooperatively with Equitable's Daily Reporter (123a-124a, 213a-214a, 339a-340a).

They discussed the problem between themselves and solicited the opinions of others, including the third member of Equitable's board of directors, W. H. Weingartner, who was also a banker and the representative of the bank which held 112 of Equitable's outstanding shares as a trustee (123a-124a). Knipe and Berky, in the exercise of their own best business judgment and in conformity with the

business advice they had received from others, rejected the first two alternatives and accepted the third; they decided to purchase the stock of North Penn (123a-124a) and did so on July 26, 1952.[3]

The reasons which prompted Knipe and Berky to purchase the stock of North Penn in 1952 were (1) to protect and (2) to promote the business of Equitable's Daily Reporter by operating the two corporations in a cooperative joint venture.

The two corporations were thereafter operated cooperatively. Illustratively, the persons working for the Weekly News have been instructed to and have always placed the interests of the Daily Reporter ahead of the interests of the Weekly News; they have worked at diverting or directing advertising to the Daily Reporter wherever possible; they have solicited advertising from small businesses not likely to be advertisers in the Daily Reporter or from new businesses in outlying areas who might thus become advertisers in the Daily Reporter if they could be made familiar with the Lansdale area by advertising in the Weekly News; they have defended the Daily Reporter against complaints and they have specifically recommended the Daily Reporter as the preferable media for advertising when asked to compare the value of advertising in the two publications. In addition, Knipe and Berky have used the Weekly News to train new employees who were then put to work at the Daily Reporter. At times, the Daily Reporter has even borrowed employees from the Weekly News to do work for the

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[3] The conclusion reached by Knipe and Berky to purchase North Penn's stock and publish the Weekly News in cooperation with and for the benefit of the Daily Reporter was a business decision with which other experienced businessmen, including not only Weingartner but also Robert I. McCracken, a publisher and a former President of the Pennsylvania Newspaper Publishers Association, agreed (202a-203a, 210a). No one testified to the contrary.

Daily Reporter (344a, 137a-139a, 158a, 178a, 195a-197a). The Weekly News has also been used as a promotional means of attracting new subscribers for the Daily Reporter. In two instances copies of the Weekly News were delivered to every house in small communities in order to whet the appetites of the members of those communities for local news. Representatives were then sent in to solicit subscriptions for the Daily Reporter. This promotional campaign almost doubled the number of the cash subscribers to the Daily Reporter in those areas[4] (133a-134a).

The idea for a subscription daily to publish and distribute a weekly throwaway was neither new nor original with Knipe and Berky in 1952. It has long been a well-known and accepted business practice in the newspaper industry for a daily newspaper to protect against the dangers of an unscrupulously operated throwaway and to enjoy the benefits of a cooperative venture by publishing and distributing its own weekly throwaway. In Pennsylvania alone weekly throwaways, to satisfy community desires for such publications, are and have been published and distributed by at least eleven daily newspapers (266a, 303a). The same practice is common on a national scale (266a-269a, 304a-329a). The publication and free distribution of the "Buyers' Guide" by Equitable, from 1939 to 1943, by Equitable's prior owner, Walter L. Sanborn, had been for the purpose of benefiting the Daily Reporter (190a, 336a).

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[4] It is customary in the newspaper industry and it has been the custom of Equitable in the operation of the Daily Reporter, throughout its history, to incur substantial expenses in promotional activities designed to increase the number of its subscribers (214a-216a). Knipe and Berky have considered other types of promotional activities for the Daily Reporter, including, for example, advertising on billboards, or in Philadelphia published newspapers, or other suburban newspapers coming into the fringes of the North Penn Valley. All would be more expensive and less effective than the operation of the Weekly News as a means of promoting the Daily Reporter (135a-136a).

The cooperative operation of North Penn's Weekly News and Equitable's Daily Reporter has, on the stipulated facts and documentary evidence, been to the financial benefit of Equitable. For example, between 1951 and 1960 Equitable has been able to increase its paid advertising lineage by over 1,200,000 lines, or over 26% (Ex. 25, 101a). Between 1952 and 1960 Equitable's paid circulation has increased by approximately 3,400 copies (from 6,495 to 9,891 copies) for an increase of over 52% (Ex. 28, 104a). From 1951 to 1960 its gross advertising billings have increased by over $172,000 (from $184,564 to $356,937), which is an increase of nearly 100% (Ex. 25, 101a). Between 1952 and 1960 Equitable's subscription income has increased by over $36,500, or 114% (Ex. 26, 102a).

The use of North Penn's Weekly News to benefit Equitable's Daily Reporter has, of course, been to the consequent detriment of North Penn. This obviously predictable fact is also completely corroborated by the uncontradicted documentary evidence. Illustratively, North Penn's advertising lineage went from 738,494 in 1951 to 177,282 in 1960, and its advertising billings went from $31,838.08 in 1951 to $5,966.66 in 1960 (Ex. 25, 101a, 231a).

The stipulated facts also established that without being fairly compensated for its services in the joint effort to increase advertising and subscriptions in Equitable's Reporter, North Penn could not have survived. The goal of using the Weekly News to benefit the Daily Reporter would have come to an end. The goal of protecting Equitable's Daily Reporter from the tentacles of the larger newspapers of the surrounding larger communities would also have come to an end.

Therefore, it was essential that North Penn be compensated for its efforts in the joint venture. The plan for payment was labelled "Advertising Participation." The calculation was made under a formula based primarily upon the

percentage of the total advertising income each had enjoyed during 1951 and 1952 while the two papers were still competing.

Under the advertising participation program the following amounts of advertising billings by Equitable were accrued to North Penn and included by the latter in its U. S. Corporation Income Tax returns (359a):

Year	Amount
1956	$24,225.28
1957	24,651.85
1958	26,468.45
1959	27,219.40
1960	31,161.49

The amounts accrued by Equitable to North Penn as having been earned by the latter in their joint effort to increase Equitable's advertising and subscription income were considered not only by Knipe and Berky, but also by banker and trustee, Weingartner, during the years he represented the bank as trustee for other Equitable shares, to be appropriate and fair for the services rendered by North Penn (204a-205a, 214a). No one has challenged the honesty of these opinions. The validity of their business judgment was corroborated by independent witnesses (208a-210a, 303a-329a).

Notwithstanding the uncontradicted testimony, documentary evidence and stipulated facts showing (a) the two corporations entered into a joint venture on the basis of the exercise of the honest business judgment of experienced newspaper publishers and (b) endeavored to compensate the joint venturers for their services, the Tax Court held that the advertising participation program payments were includable in Equitable's gross income and constituted dividends to Knipe and Berky because the Tax Court Judge found no business purpose in the joint venture. The Court of Appeals for the Third Circuit affirmed per curiam.

REASONS FOR GRANTING THE WRIT.

1. The Court Below Did Exactly What This Court Said, in Commissioner v. Culbertson, 337 U. S. 733 (1949), Should Not Be Done.

The petitioners' basic contention can be summarized as follows: North Penn was acquired by Knipe and Berky in 1952 for the purpose of promoting and protecting the advertising and subscription income of Equitable's Daily Reporter. North Penn and Equitable entered into a joint venture to conduct their business in such manners as would increase the advertising and subscription income of Equitable. In return it was agreed that North Penn should share in the proceeds of the joint venture. The two corporations did conduct their businesses cooperatively. The effort of the joint venture to increase Equitable's circulation and advertising was completely successful.

All the basic facts relied upon by petitioners were found to be true by the Tax Court (339a-343a, 344a, 346a-347a, 352a, 354a, 355a, 361a-362a).

The Tax Court Judge, however, ignored the findings and evidence proving the existence of the joint venture and the performance of services by North Penn in the cooperative effort. He held that he could ignore the agreement of the parties to conduct a joint venture because he saw no business purpose being served by it (375a).

In applying that test, the Tax Court made the exact mistake which was condemned by this Court in *Commissioner v. Culbertson*, 337 U. S. 733 (1949). In the *Culbertson* case this Court stated that the correct test is whether the parties in fact *intended* to join together as partners (or,

as in the instant cases, joint venturers) not whether the Tax Court thought the joint effort was important to the business. This Court said, in language equally pertinent to the instant cases (at pp. 743-745):

> "But the Tax Court did not view the question as one concerning the bona fide intent of the parties to join together as partners. Not once in its opinion is there even an oblique reference to any lack of intent on the part of respondent and his sons to combine their capital and services 'for the purpose of carrying on the business.' Instead, the court, focusing entirely upon concepts of 'vital services' and 'original capital,' simply decided that the alleged partners had not satisfied those tests when the facts were compared with those in the *Tower* case . . . But such a determination is not conclusive, and that is the vice in the 'tests' adopted by the Tax Court. It assumes that there is no room for an honest difference of opinion as to whether the services or capital furnished by the alleged partner are of sufficient importance to justify his inclusion in the partnership. *If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient. The Tower case did not purport to authorize the Tax Court to substitute its judgment for that of the parties;* it simply furnished some guides to the determination of their true intent . . ." (Italics supplied.)

2. The Court Below Ignored This Court's Repeated Admonition that in Tax Cases It Is the Substance, Not the Form, of a Transaction which Must Govern.[5]

The Tax Court rejected petitioners' alternative contention that even if the advertising participation payments to North Penn should have been treated as income to Equitable, nevertheless, the payments could have been deducted as ordinary and necessary business expenses. The Tax Court Judge offered no explanation for this conclusion (375a). The respondent's argument proceeded upon the erroneous assumption that Equitable was merely paying North Penn to cover its expenses and losses for a purpose wholly unrelated to Equitable's business. However, that is not the present case. Equitable showed that it was paying North Penn for an ordinary and necessary service on behalf of Equitable's Daily Reporter.

Respondent's briefs in the Courts below, ignored the uncontradicted oral and documentary evidence that throughout the United States daily newspapers are protecting themselves against hostile weeklies by publishing their own weeklies. Respondent did not question that in such situations the expense to a daily of publishing a weekly is deductible as an expense which is ordinary and necessary in the newspaper industry. Respondent even recognized that the expenses incurred in publishing the Weekly News would have been deductible had Equitable published the weekly

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[5] The source of this often-repeated principle may well be **Weiss v. Stearn**, 265 U. S. 242 (1924), where this Court said (at p. 254): "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants; and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form."

itself; for example, if the two corporations had merged in 1952. Respondent further acknowledged that the expenses would have been deductible if Equitable (rather than Knipe and Berky) had acquired North Penn's stock so as to justify the filing of consolidated returns by the two corporations. These concessions totally destroyed the respondent's contention that the expenses were not ordinary and necessary. The identical business purpose is served whether there are one or two corporate entities doing the publishing of the subscription daily and the weekly throwaway. Further, the identical business purpose is served whether or not the two corporations were entitled to file a consolidated tax return.

3. The Courts Below Have Invented a Theory of Constructive Dividends Which Is of Far Reaching Consequences But Is Without Legislative or Judicial Basis.

The only case relied upon by the Courts below was *Helvering v. Horst*, 311 U. S. 112 (1940). The effort to apply the holding of that case to the facts of this case reflects a misunderstanding and distortion of this Court's decision which would have far-reaching effects on the administration of the tax laws.

The doctrine of constructive receipt is at best a legal fiction which is used to confer income upon a person who has received the benefit from a payment or transfer of money or other property, although the one so charged has not actually received the money or property. The uncontradicted, and in many instances the stipulated, evidence in the present case shows that Knipe and Berky have accrued no such unreported "benefit" and there is no reason for resorting to the legal fiction of a constructive dividend.

The Tax Court's opinion holding that Knipe and Berky received constructive dividends by reason of the advertis-

ing participation program boils down to (a) the fact that they own stock in both Equitable and North Penn; (b) the erroneous assumption that the advertising participation program payments served no business purpose; and (c) the speculation that Knipe and Berky *could* have caused Equitable to distribute the same amounts of money to them as individuals rather than to North Penn. In so reasoning, the Tax Court had to ignore completely the substantial, uncontradicted and stipulated evidence, both oral and documentary, offered not just by petitioners but by five other witnesses as well. That evidence proved (1) that the advertising participation program payments were made to North Penn by Equitable for the sole purpose of fairly compensating North Penn for its successful efforts to promote and to protect the advertising revenues and subscription income of Equitable; (2) that the payments were made as the result of the exercise of the sound business judgment of Equitable's board of directors which included not only Knipe and Berky but a third and independent director (W. H. Weingartner) who represented a fiduciary which held over 15% of Equitable's stock; and (3) that Knipe and Berky never received any direct or indirect benefit from the payments which were almost entirely consumed by North Penn's operating expenses. On all these points the evidence is clear, convincing, overwhelming and uncontradicted.

First, the Tax Court agreed that at the time Knipe and Berky bought North Penn's stock with the plan to operate it in a cooperative but non-competitive manner they were exercising their business judgment and they knew it would probably be necessary to pay over to North Penn a portion of the income of Equitable in order to keep North Penn in operation (340a). The Tax Court also found that without the payments under the program, North Penn could not have survived (364a). The existence of these facts, all

found by the Tax Court, completely and conclusively negates any implication that the advertising participation program payments served no business purpose of Equitable and paid for no services by North Penn but, on the contrary, constituted constructive dividends to Berky or Knipe.

Secondly, the advertising participation program payments made by Equitable to North Penn resulted from the exercise of the business judgment of Equitable's full board of directors. The question was raised every year and the agreement to continue the program was annually approved. The Tax Court so found (352a) and the recorded minutes of Equitable show the annual ratification of the intercompany advertising participation program (275a-281a). In this regard the testimony of W. H. Weingartner is of importance (202a-206a). His testimony establishes that he was an officer of the Philadelphia National Bank which was trustee of three trusts which held 112 of the 740 outstanding shares of Equitable and in that capacity served on Equitable's board of directors from 1948 through 1958. He attended all of the annual and special meetings. He was familiar with Equitable's business and on frequent occasions he discussed business problems with Knipe and Berky. More importantly, in 1952, the advertising participation was explained to him, and he voted in favor of that program because he believed the payments were fair and appropriate. These facts conclusively prove that the advertising participation program payments were not made to North Penn "solely" at the behest of Knipe and Berky as stockholders of both corporations, but were made after full discussion and with the approval of the third and independent member of the board of directors. Moreover, Mr. Weingartner and the trusts which he represented could not and would not have agreed to the program had not the purpose of the program been of material benefit to Equitable. If the program had merely

been to benefit Knipe and Berky, then Mr. Weingartner as a director and as a representative of a trustee would have been under the dual fiduciary obligation to oppose the transaction and prevent its consummation.[6] Mr. Weingartner did not oppose. On the contrary, he approved the transaction as being beneficial to Equitable.

Thirdly, neither Knipe nor Berky had any personal obligations to satisfy any of the obligations of North Penn. They received no benefit from North Penn's receipt of the money by way of dividends, salaries, loans or any other distributions or benefits from North Penn. Neither the Commissioner nor the Tax Court have ever stated otherwise. The most that the Tax Court judge could say was that "Knipe and Berky *might* properly have caused Equitable in each of the years in issue to distribute to them directly the amounts of its income totaling the sums it omitted from its income tax returns, and paid to North Penn during the respective years . . . " (402a). (Italics supplied.) That statement is admittedly sheer speculation. What the documentary evidence actually shows is that substantial portions of North Penn's share of the advertising participation program were consumed by it simply keeping itself in existence. Those sums were paid for labor and material and did not even include salaries, let alone dividends, to Knipe and Berky. Whereas, North Penn has received a total of $133,726.47 through 1960 under the advertising participation program, it consumed $89,540.92 simply staying in business for the purposes of trying to protect and increase the profitableness of Equitable.

The Tax Court judge's reliance upon *Helvering v. Horst*,

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[6] See **Higgins v. Shenango Pottery Company**, 279 F. 2d 46 (3rd Cir. 1960), cert. den. 364 U. S. 899 (1960); **Rivoli Theatre Co. v. Allison**, 396 Pa. 343, 152 A. 2d 449 (1959); **Comerford Estate**, 388 Pa. 278, 294, 130 A. 2d 458 (1957), for the relevant principles governing the conduct of directors and trustees.

311 U. S. 112 (1940), is misplaced. That case, which involved a gift by a father of unmatured bond coupons to his son, has no relevance to the present facts.

But aside from that basic distinction, the Tax Court's application of *Helvering v. Horst*, to the instant case completely ignores two other elements. In applying the *Horst* case, the Tax Court said (405a):

> ". . . As stockholders and officers of Equitable, Knipe and Berky, had the power to cause it to dispose of its income and accumulated earnings and profits . . . Under the *Horst* case, the foregoing power was the equivalent of ownership of the income and accumulated earnings and profits involved. The exercise of that power to procure payment of income and accumulated earnings and profits in the amounts in question to North Penn was the enjoyment and hence the realization of income by those who exercised the power, namely, Knipe and Berky."

That theory advanced by the Tax Court glosses over the fact that the third member of Equitable's board of directors, who represented a trustee holding 112 shares of stock, also voted to approve the advertising participation program and the payments made under it. Thus, if the Tax Court's application of *Helvering v. Horst* is correct, it would require the attribution of constructive dividends to the three trusts as well, since the trustee likewise approved the payments, and, under the Tax Court's theory, it too exercised the power to procure payment of income to North Penn which constituted "the enjoyment and hence the realization of income." That is not the law and never has been the law, but it serves to point up the illogical and erroneous extension of the doctrine laid down by *Helvering v. Horst* which the Tax Court employed to attribute income where there was none.

The Tax Court's analysis likewise glosses over the fact that Knipe and Berky did not have unfettered control over Equitable's assets and earnings; they were answerable to the minority stockholders to whom they owed a fiduciary duty under Pennsylvania law: Business Corporation Law, 15 P. S. §2852-408. There is nothing in the record to support the argument that Knipe and Berky dissipated the funds of Equitable in callous disregard of the rights of the substantial minority stockholders. The Commissioner made no such contention and the Tax Court made no such finding of fact.

Moreover, it is clear from the facts in this case that Knipe and Berky, as stockholders of North Penn, have not received anything which may be considered a benefit. They have not received salaries, loans, dividends or any other direct or indirect benefit from North Penn. The amounts which Equitable paid to North Penn were used to pay for labor and material, and the finances of that corporation have been such that if Knipe and Berky were to liquidate it there would be little or nothing left for distribution to them. By the same token, viewing Knipe and Berky as stockholders of Equitable, the advertising participation program payments have not resulted in any benefit to them so as to give rise to taxable income. The only benefit which Knipe and Berky might be said to have received from Equitable results from the increase of North Penn's total assets and earnings thus making the stock in the hands of Knipe and Berky more valuable. However, such consequences are expected to flow in all such transactions entered into by a corporation and do not give rise to taxable benefits to shareholders. The Tax Court cannot be heard to say that just because a transaction entered into at the behest of a corporation's stockholders results in gain to the company that the stockholders should be immediately taxed on that

gain even though it is not distributed to them. The concept of our tax laws is to tax gain when and only when it is realized. See *Holsey v. Commissioner*, 258 F. 2d 865 (3d Cir. 1958); *Tucker v. Commissioner*, 226 F. 2d 177 (8th Cir. 1955); *Ruben v. Commissioner*, 97 F. 2d 926 (8th Cir. 1938); *Differential Steel Car Company*, 16 T. C. 413 (1951), Acq. 1951-2 C. B. 2.

Application of the doctrine of constructive dividends to the facts of this case extends the scope of that legal fiction beyond the bounds of any decided case and beyond the definition of income contemplated by the Sixteenth Amendment and any Revenue Act since 1913.

CONCLUSION.

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

GORDON W. GERBER,
Attorney for Petitioners.

KENNETH W. GEMMILL,
DAVID E. SEYMOUR,
DECHERT, PRICE & RHOADS,
Of Counsel.

APPENDIX A.

EQUITABLE PUBLISHING COMPANY v.
COMMISSIONER OF INTERNAL REVENUE;

HOWARD C. BERKY and EMMA M. BERKEY, his wife,
v. COMMISSIONER OF INTERNAL REVENUE; and

GEORGE W. KNIPE and DOROTHY K. KNIPE, his wife,
v. COMMISSIONER OF INTERNAL REVENUE.

PETITIONS FOR REVIEW OF DECISIONS OF THE TAX COURT OF THE UNITED STATES.

Argued February 10, 1966
Before McLAUGHLIN, FORMAN AND GANEY, *Circuit Judges*

OPINION OF THE COURT.

(Filed March 8, 1966)

PER CURIAM.

We are concerned here solely with the issues arising out of payments by Equitable Publishing Company during the taxable years involved to North Penn Publishing Co. The stock of the North Penn corporation was wholly owned

by taxpayers Knipe and Berky, the majority and controlling stockowners of Equitable. In our judgment the facts clearly justified the holding of the Tax Court that the sums totaling approximately $142,000 so paid by Equitable to North Penn under the guise of "advertising participation program payments" were income of Equitable and properly taxable to it; that such payments could not be deducted by Equitable as business expense; that said payments were taxable to Knipe and Berky as constructive dividends and that the deficiencies were not barred by the statute of limitations.

The decision of the Tax Court will be affirmed.

A True Copy:

Teste:

Clerk of the United States
Court of Appeals for the
Third Circuit.

APPENDIX B.

EQUITABLE PUBLISHING COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JUDGMENT.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, ad-

judged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

ATTEST:
IDA O. CRESKOFF,
Clerk.

March 8, 1966.

HOWARD C. BERKY and EMMA M. BERKEY,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JUDGMENT.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

ATTEST:
IDA O. CRESKOFF,
Clerk.

March 8, 1966.

GEORGE W. KNIPE and DOROTHY K. KNIPE,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

JUDGMENT.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed.

ATTEST:
IDA O. CRESKOFF,
Clerk.

March 8, 1966.

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 194

EQUITABLE PUBLISHING COMPANY, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In the taxable years 1956 through 1960, petitioner Equitable Publishing Company failed to report as income more than $142,000, which it had obtained from the sale of advertising and diverted to North Penn Publishing Company, a corporation wholly owned by Equitable's controlling shareholders, petitioners Berky and Knipe. Petitioners claimed that the diverted funds were not actually earned by Equitable but were earned by North Penn for its contribution to a joint venture. The Tax Court found, however, that petitioners failed to establish either the existence of the claimed joint venture or the performance by North Penn of any substantial services for Equitable so as to render the diverted funds deducti-

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ble by the latter as a business expense (R. 362a–375a).[1] The court also found that the payments in question were taxable to Berky and Knipe as constructive dividends (R. 401a–407a, 410a–411a). Recognizing that the Tax Court's decision primarily turned on questions of fact and that the record amply supported the court's findings and conclusions, the court of appeals affirmed *per curiam* (Pet. App. A; 356 F. 2d 514). The decision below is correct and is not in conflict with the decision of any other court; there is no occasion for further review.

1. In 1952, Berky and Knipe each purchased half the stock of North Penn, which published a weekly advertising "throw-away" in the same area served by Equitable's daily newspaper. From 1952 to 1955 Equitable consistently made a profit, though it never paid a dividend (R. 338a, 354a), and North Penn consistently lost money, having a loss carryover in 1955 in excess of $31,000 (R. 346a). In 1955, the "advertising participation plan" which underlies this litigation was devised by petitioners' accountant and adopted by Equitable's shareholders (R. 346a–347a). In essence, the "plan" provided for annual distributions of a certain arbitrary percentage of Equitable's surplus earnings to North Penn.[2]

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[1] "R" refers to the petitioners' appendix filed in the court of appeals.

[2] Among the advantages of the complex formula, according to the minutes of Equitable's stockholders' meeting of January 17, 1955, were those "inuring to the Federal, State and Local Governments" (R. 346a). This is apparently a reference to the tax benefits expected to accrue from the diversion of Equitable's profits to the profitless North Penn.

Petitioners contend that the diverted funds, which exceeded the amounts reported by Equitable as net income in each of the years in question (R. 373a–374a), were earned by North Penn for promotional and protective services performed pursuant to an agreement with, and for the benefit of, Equitable. But the terms of the alleged agreement appear nowhere in the record. Although they suggested vaguely that North Penn promoted Equitable's advertising sales and deterred competitive weeklies from entering the market, petitioners have failed to show with particularity what services North Penn performed or how the alleged services had a value of $142,000. Indeed, the record shows that, during the years in question, Equitable's advertising income and lineage as well as its payments to North Penn steadily increased, while North Penn's advertising income and lineage and the size of its staff steadily declined (R. 355a). Since there was no change in the operations of North Penn after the adoption of the "plan" (R. 353a), it would appear on petitioners' theory that Equitable was paying increasingly more for increasingly less.

In fact, we submit, Equitable received nothing at all for the payments to North Penn. As the Tax Court correctly found, "the several advertising income participation agreements entered into by Equitable and North Penn * * * did not constitute real and genuine business transactions entered into by Equitable for profit or for any other proper business purpose but were for the mere purpose of distributing to North Penn earnings and profits of Equitable

without a business basis therefor" (R. 375a). In light of this holding, petitioners cannot properly contend, as they do (Pet. 12), that the existence of an actual joint venture was found by the Tax Court; nor can they properly rely on this Court's decision in *Commissioner* v. *Culbertson,* 337 U.S. 733. That opinion makes clear that the existence of a joint venture or partnership depends on the facts of each particular case and that the trial court is not required to find that a joint venture exists merely on the parties' assertion that a joint venture was intended.

2. It follows from the Tax Court's finding that the diversions from Equitable to North Penn were not for any substantial business purpose that the $142,000 of income unreported by Equitable is not deductible by it as an ordinary and necessary business expense. It is well settled that a corporate taxpayer cannot deduct payments made to cover expenses of its subsidiary or affiliate unless they are made to further the taxpayer's own business wholly apart from that of the recipient. *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590; *Dodd* v. *Commissioner,* 298 F. 2d 570 (C.A. 4); *Columbian Rope Co.* v. *Commissioner,* 42 T.C. 800, 815. Here the diverted funds not only covered North Penn's expenses but enabled it to make a small profit. These payments can in no way be considered as furthering Equitable's own business; on the contrary, they produced a marked reduction in Equitable's income (R. 373a).

During the relevant period, Equitable and North Penn were distinct corporate entities (R. 343a). They were related only in that Berky and Knipe,

sole owners of North Penn, were the controlling shareholders of Equitable.[3] That petitioners might have been able to achieve the tax benefits they claimed through a merger or other joinder of the two corporations (see Pet. 14–15), is without significance here. Having chosen to operate the two corporations separately, they may not claim the tax benefits of consolidation.

3. The courts below properly held that the funds diverted from Equitable to North Penn constituted constructive dividends to Berky and Knipe, who controlled the former and entirely owned the latter corporation. The amount of corporate funds taken by shareholders for their personal benefit, even if not paid directly into their hands, is taxable to the shareholders as a constructive dividend. See *Commissioner* v. *Makransky*, 321 F. 2d 598, 601–602 (C.A. 3); *Montgomery Engineering Co.* v. *United States*, 230 F. Supp. 838 (D. N.J.), affirmed *per curiam*, 344 F. 2d 996 (C.A. 3). That the disbursing corporation may have other shareholders who do not receive payments or benefits on a *pro rata* basis is immaterial. See, *e.g.*, *Oyster Shell Products Corp.* v. *Commissioner*, 313 F. 2d 449, 452, n. 4 (C.A. 2); *Lengsfield* v. *Commissioner*, 241 F. 2d 508, 511 (C.A. 5).

Equitable failed to prove that it purchased goods or services from North Penn, and if did not claim that the payments in question were made as a gift or loan. The only other means by which the diverted

[3] Berky and Knipe's ownership of Equitable's 740 non-Treasury shares increased during the period in question from 313 shares each to 369 shares each (R. 337a–338a).

funds could properly have been transferred from Equitable was through dividends to Berky and Knipe, who in turn would pay the money over to North Penn. Although no formal dividends were declared, Berky and Knipe, through their control of Equitable, were able to direct the disposition of that corporation's surplus as they saw fit.[4] As the Tax Court found, they used this power to cause Equitable to make the payments in question to North Penn (R. 402a). There is no merit in petitioners' argument (Pet. 20) that Berky and Knipe received no benefit from these payments to North Penn, their wholly-owned corporation. *Cf. Montgomery Engineering Co.* v. *United States, supra* (payment to widow of former corporate executive directed by controlling shareholder). Berky and Knipe's exercise of their power to control the disposition of Equitable's income in the manner revealed by the present record was properly held to result in income taxable to each of them during the years in question. See *Helvering* v. *Horst,* 311 U.S. 112.

[4] The bank which was trustee for most of Equitable's other shareholders was trying to sell the shares held by it during the period in question (R. 205a–206a). The record fails to support petitioner's contention (Pet. 17–18) that the role played by the trustee in Equitable's affairs was such as to negate the possibility that Berky and Knipe were able to divert Equitable's funds for their own purposes.

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

THURGOOD MARSHALL,
Solicitor General.

MITCHELL ROGOVIN,
Assistant Attorney General.

MELVA M. GRANEY,
JONATHAN S. COHEN,
Attorneys.

JULY 1966.

U.S. GOVERNMENT PRINTING OFFICE: 1966